

borrowed to purchase stock in an automobile company by an individual who does not work for that company would indicate a personal investment and a consumer purpose.

- The size of the transaction. The larger the size of the transaction, the more likely the loan will have a business purpose. For example, if the loan is for a \$5,000,000 real estate transaction, that might indicate a business purpose.
- The amount of income derived from the property acquired by the loan proceeds relative to the borrower's total income. The lesser the income derived from the acquired property, the more likely the loan will have a consumer purpose. For example, if the borrower has an annual salary of \$100,000 and receives about \$500 in annual dividends from the acquired property, that would indicate a consumer purpose.

All five factors must be evaluated before the lender can conclude that disclosures are not necessary. Normally, no one factor, by itself, is sufficient reason to determine the applicability of Regulation Z. In any event, the financial institution may routinely furnish disclosures to the consumer. Disclosure under such circumstances does not control whether the transaction is covered, but can assure protection to the financial institution and compliance with the law.

Determination of Finance Charge and APR

Finance Charge (Open-End and Closed-End Credit)

§226.4

The finance charge is a measure of the cost of consumer credit represented in dollars and cents. Along with APR disclosures, the disclosure of the finance charge is central to the uniform credit cost disclosure envisioned by the TILA.

The finance charge does not include any charge of a type payable in a comparable cash transaction. Examples of charges payable in a comparable cash transaction may include taxes, title, license fees, or registration fees paid in connection with an automobile purchase.

Finance charges include any charges or fees payable directly or indirectly by the consumer and imposed directly or indirectly by the financial institution either as an incident to or as a condition of an extension of consumer credit. The finance charge on a loan always includes any interest charges and often, other charges. Regulation Z includes examples, applicable both to open-end and closed-end credit transactions, of what must, must not, or need not be included in the disclosed finance charge (§226.4(b)).

Accuracy Tolerances (Closed-End Credit)

§226.18(d) & §226.23(h)

Regulation Z provides finance charge tolerances for legal accuracy that should not be confused with those provided in the TILA for reimbursement under regulatory agency orders.

As with disclosed APRs, if a disclosed finance charge were legally accurate, it would not be subject to reimbursement.

Under TILA and Regulation Z, finance charge disclosures for open-end credit must be accurate since there is no tolerance for finance charge errors. However, both TILA and Regulation Z permit various finance charge accuracy tolerances for closed-end credit.

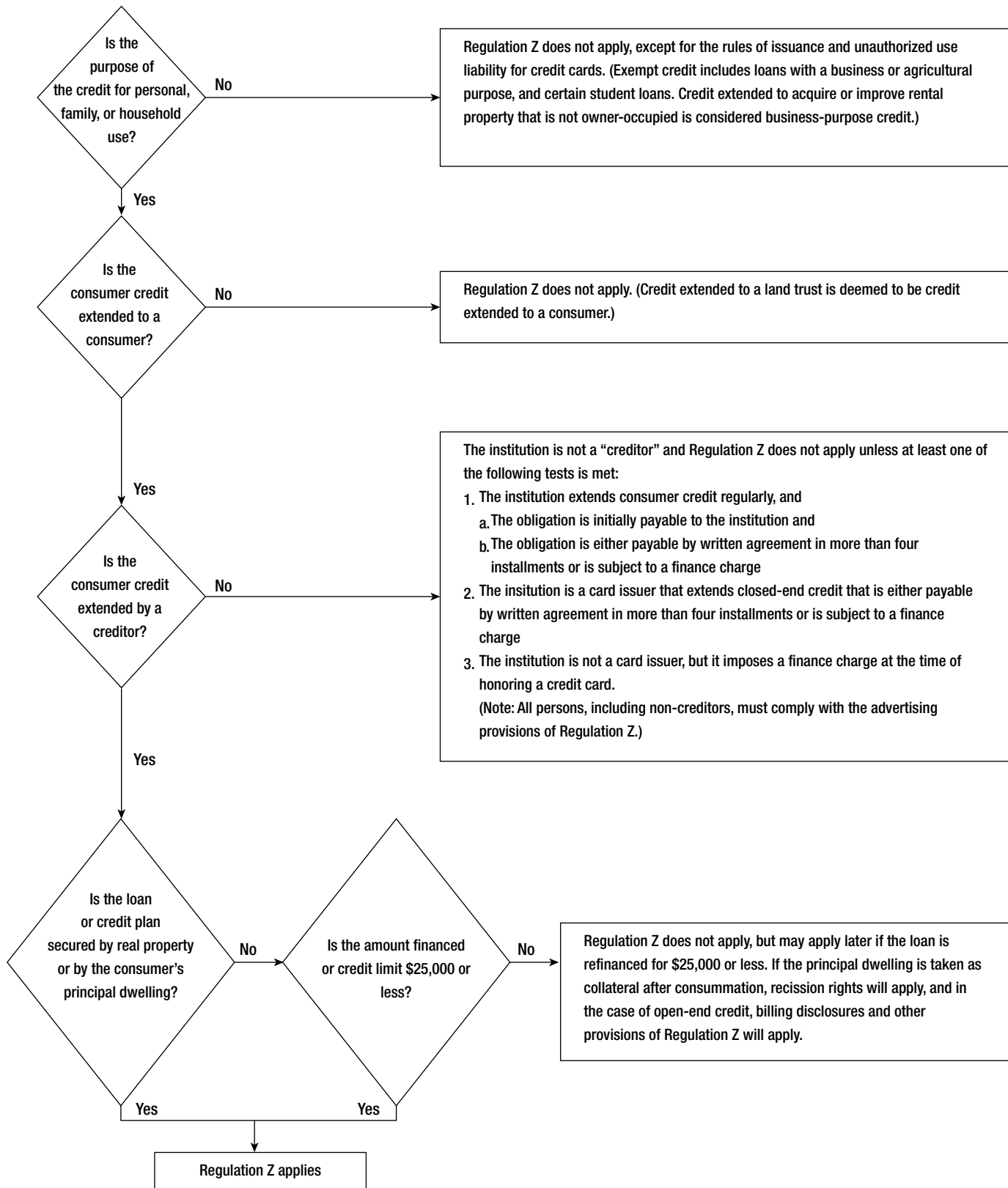
Tolerances for the finance charge in a closed-end transaction are generally \$5 if the amount financed is less than or equal to \$1,000 and \$10 if the amount financed exceeds \$1,000. Tolerances for certain transactions consummated on or after September 30, 1995 are noted below.

- Credit secured by real property or a dwelling (closed-end credit only):
 - The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than \$100.
 - Overstatements are not violations.
- Rescission rights after the three-business-day rescission period (closed-end credit only):
 - The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than one-half of 1 percent of the credit extended.
 - The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than 1 percent of the credit extended for the initial and subsequent refinancings of residential mortgage transactions when the new loan is made at a different financial institution. (This excludes high cost mortgage loans subject to §226.32, transactions in which there are new advances, and new consolidations.)
- Rescission rights in foreclosure:
 - The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than \$35.
 - Overstatements are not considered violations.
 - The consumer can rescind if a mortgage broker fee is not included as a finance charge.

NOTE: Normally, the finance charge tolerance for a rescindable transaction is either 0.5 percent of the credit transaction or, for certain refinancings, 1 percent of the credit transaction. However, in the event of a foreclosure, the consumer may exercise the right of rescission if the disclosed finance charge is understated by more than \$35.

See the “Finance Charge Tolerances” charts within these examination procedures for help in determining appropriate finance charge tolerances.

Coverage Considerations Under Regulation Z



Calculating the Finance Charge (Closed-End Credit)

One of the more complex tasks under Regulation Z is determining whether a charge associated with an extension of credit must be included in, or excluded from, the disclosed finance charge. The finance charge initially includes any charge that is, or will be, connected with a specific loan. Charges imposed by third parties are finance charges if the financial institution requires use of the third party. Charges imposed by settlement or closing agents are finance charges if the bank requires the specific service that gave rise to the charge and the charge is not otherwise excluded. The “Finance Charge Tolerances” charts (pages V-1.14 to V-1.16) briefly summarize the rules that must be considered.

Prepaid Finance Charges §226.18(b)

A prepaid finance charge is any finance charge paid separately to the financial institution or to a third party, in cash or by check before or at closing, settlement, or consummation of a transaction, or withheld from the proceeds of the credit at any time.

Prepaid finance charges effectively reduce the amount of funds available for the consumer’s use, usually before or at the time the transaction is consummated.

Examples of finance charges frequently prepaid by consumers are borrower’s points, loan origination fees, real estate construction inspection fees, odd days’ interest (interest attributable to part of the first payment period when that period is longer than a regular payment period), mortgage guarantee insurance fees paid to the Federal Housing Administration, private mortgage insurance (PMI) paid to such companies as the Mortgage Guaranty Insurance Company (MGIC), in non-real-estate transactions, and credit report fees.

Precomputed Finance Charges

A precomputed finance charge includes, for example, interest added to the note amount that is computed by the add-on, discount, or simple interest methods. If reflected in the face amount of the debt instrument as part of the consumer’s obligation, finance charges that are not viewed as prepaid finance charges are treated as precomputed finance charges that are earned over the life of the loan.

Instructions for the Finance Charge Chart (page V-1.6)

The finance charge initially includes any charge that is, or will be, connected with a specific loan. Charges imposed by third parties are finance charges if the creditor requires use of the third party. Charges imposed on the consumer by a settlement agent are finance charges only if the creditor requires the particular services for which the settlement agent is charging the borrower and the charge is not otherwise excluded from the finance charge.

Immediately below the finance charge definition, the chart presents five captions applicable to determining whether a loan related charge is a finance charge.

The first caption is charges always included. This category focuses on specific charges given in the regulation or commentary as examples of finance charges.

The second caption, charges included unless conditions are met, focuses on charges that must be included in the finance charge unless the creditor meets specific disclosure or other conditions to exclude the charges from the finance charge.

The third caption, conditions, focuses on the conditions that need to be met if the charges identified to the left of the conditions are permitted to be excluded from the finance charge. Although most charges under the second caption may be included in the finance charge at the creditor’s option, third party charges and application fees (listed last under the third caption) must be excluded from the finance charge if the relevant conditions are met. However, inclusion of appraisal and credit report charges as part of the application fee is optional.

The fourth caption, charges not included, identifies fees or charges that are not included in the finance charge under conditions identified by the caption. If the credit transaction is secured by real property or the loan is a residential mortgage transaction, the charges identified in the column, if they are bona fide and reasonable in amount, must be excluded from the finance charge. For example, if a consumer loan is secured by a vacant lot or commercial real estate, any appraisal fees connected with the loan must not be included in the finance charge.

The fifth caption, charges never included, lists specific charges provided by the regulation as examples of those that automatically are not finance charges (e.g., fees for unanticipated late payments).

Annual Percentage Rate Definition §226.22 (Closed-End Credit)

Credit costs may vary depending on the interest rate, the amount of the loan and other charges, the timing and amounts of advances, and the repayment schedule. The APR, which must be disclosed in nearly all consumer credit transactions, is designed to take into account all relevant factors and to provide a uniform measure for comparing the cost of various credit transactions.

The APR is a measure of the cost of credit, expressed as a nominal yearly rate. It relates the amount and timing of value received by the consumer to the amount and timing of payments made. The disclosure of the APR is central to the uniform credit cost disclosure envisioned by the TILA.

Finance Charge Chart

Finance Charge – Dollar cost of Consumer Credit: It includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as a condition of or incident to the extension of credit.



The value of a closed-end credit APR must be disclosed as a single rate only, whether the loan has a single interest rate, a variable interest rate, a discounted variable interest rate, or graduated payments based on separate interest rates (step rates), and it must appear with the segregated disclosures. Segregated disclosures are grouped together and do not contain any information not directly related to the disclosures required under §226.18.

Since an APR measures the total cost of credit, including costs such as transaction charges or premiums for credit guarantee insurance, it is not an “interest” rate, as that term is generally used. APR calculations do not rely on definitions of interest in state law and often include charges, such as a commitment fee paid by the consumer, that are not viewed by some state usury statutes as interest. Conversely, an APR might not include a charge, such as a credit report fee in a real property transaction, which some state laws might view as interest for usury purposes. Furthermore, measuring the timing of value received and of payments made, which is essential if APR calculations are to be accurate, must be consistent with parameters under Regulation Z.

The APR is often considered to be the finance charge expressed as a percentage. However, two loans could require the same finance charge and still have different APRs because of differing values of the amount financed or of payment schedules. For example, the APR is 12 percent on a loan with an amount financed of \$5,000 and 36 equal monthly payments of \$166.07 each. It is 13.26 percent on a loan with an amount financed of \$4,500 and 35 equal monthly payments of \$152.18 each and final payment of \$152.22. In both cases the finance charge is \$978.52. The APRs on these example loans are not the same because an APR does not only reflect the finance charge. It relates the amount and timing of value received by the consumer to the amount and timing of payments made.

The APR is a function of:

- The amount financed, which is not necessarily equivalent to the loan amount. If the consumer must pay at closing a separate 1 percent loan origination fee (prepaid finance charge) on a \$100,000 residential mortgage loan, the loan amount is \$100,000, but the amount financed would be \$100,000 less the \$1,000 loan fee, or \$99,000.
- The finance charge, which is not necessarily equivalent to the total interest amount.
 - If the consumer must pay a \$25 credit report fee for an auto loan, the fee must be included in the finance charge. The finance charge in that case is the sum of the interest on the loan (i.e., interest generated by the application of a percentage rate against the loan amount) plus the \$25 credit report fee.

- If the consumer must pay a \$25 credit report fee for a home improvement loan secured by real property, the credit report fee may be excluded from the finance charge. The finance charge in that case would be only the interest on the loan.
- Interest, which is defined by state or other federal law, is not defined by Regulation Z.
- The payment schedule, which does not necessarily include only principal and interest (P + I) payments.
 - If the consumer borrows \$2,500 for a vacation trip at 14 percent simple interest per annum and repays that amount with 25 equal monthly payments beginning one month from consummation of the transaction, the monthly P + I payment will be \$115.87, if all months are considered equal, and the amount financed would be \$2,500. If the consumer’s payments are increased by \$2.00 a month to pay a non-financed \$50 loan fee during the life of the loan, the amount financed would remain at \$2,500 but the payment schedule would be increased to \$117.87 a month, the finance charge would increase by \$50, and there would be a corresponding increase in the APR. This would be the case whether or not state law defines the \$50 loan fee as interest.
 - If the loan above has 55 days to the first payment and the consumer prepays interest at consummation (\$24.31 to cover the first 25 days), the amount financed would be \$2,500 - \$24.31, or \$2,475.69. Although the amount financed has been reduced to reflect the consumer’s reduced use of available funds at consummation, the time interval during which the consumer has use of the \$2,475.69, 55 days to the first payment, has not changed. Since the first payment period exceeds the limitations of the regulation’s minor irregularities provisions (*see* §226.17(c)(4)), it may not be treated as regular. In calculating the APR, the first payment period must not be reduced by 25 days (i.e., the first payment period may not be treated as one month).

Financial institutions may, if permitted by state or other law, precompute interest by applying a rate against a loan balance using a simple interest, add-on, discount or some other method, and may earn interest using a simple interest accrual system, the Rule of 78’s (if permitted by law) or some other method. Unless the financial institution’s internal interest earnings and accrual methods involve a simple interest rate based on a 360-day year that is applied over actual days (even that is important only for determining the accuracy of the payment schedule), it is not relevant in calculating an APR, since an APR is not an interest rate (as that term is commonly used under state or other law). Since the APR normally needs not rely on the internal accrual systems of a bank, it always may be computed after the loan terms have been agreed upon (as long as it is disclosed before actual consummation of the transaction).

Special Requirements for Calculating the Finance Charge and APR

Proper calculation of the finance charge and APR are of primary importance. The regulation requires that the terms “finance charge” and “annual percentage rate” be disclosed more conspicuously than any other required disclosure. The finance charge and APR, more than any other disclosures, enable consumers to understand the cost of the credit and to comparison shop for credit. A creditor’s failure to disclose those values accurately can result in significant monetary damages to the creditor, either from a class action lawsuit or from a regulatory agency’s order to reimburse consumers for violations of law.

NOTE: If an annual percentage rate or finance charge is disclosed incorrectly, the error is not, in itself, a violation of the regulation if:

- *The error resulted from a corresponding error in a calculation tool used in good faith by the financial institution.*
- *Upon discovery of the error, the financial institution promptly discontinues use of that calculation tool for disclosure purposes.*
- *The financial institution notifies the Federal Reserve Board in writing of the error in the calculation tool.*

When a financial institution claims a calculation tool was used in good faith, the financial institution assumes a reasonable degree of responsibility for ensuring that the tool in question provides the accuracy required by the regulation. For example, the financial institution might verify the results obtained using the tool by comparing those results to the figures obtained by using another calculation tool. The financial institution might also verify that the tool, if it is designed to operate under the actuarial method, produces figures similar to those provided by the examples in appendix J to the regulation. The calculation tool should be checked for accuracy before it is first used and periodically thereafter.

Subpart B—Open-End Credit

The following is not a complete discussion of the open-end credit requirements in the Truth in Lending Act. Instead, the information provided below is offered to clarify otherwise confusing terms and requirements. Refer to §226.5 through §226.16 and related commentary for a more thorough understanding of the Act.

Finance Charge (Open-End Credit) §226.6(a)

Each finance charge imposed must be individually itemized. The aggregate total amount of the finance charge need not be disclosed.

Determining the Balance and Computing the Finance Charge

The examiner must know how to compute the balance to which the periodic rate is applied. Common methods used are the previous balance method, the daily balance method, and the average daily balance method, which are described as follows:

- **Previous balance method.** The balance on which the periodic finance charge is computed is based on the balance outstanding at the start of the billing cycle. The periodic rate is multiplied by this balance to compute the finance charge.
- **Daily balance method.** A daily periodic rate is applied to either the balance on each day in the cycle or the sum of the balances on each of the days in the cycle. If a daily periodic rate is multiplied by the balance on each day in the billing cycle, the finance charge is the sum of the products. If the daily periodic rate is multiplied by the sum of all the daily balances, the result is the finance charge.
- **Average daily balance method.** The average daily balance is the sum of the daily balances (either including or excluding current transactions) divided by the number of days in the billing cycle. A periodic rate is then multiplied by the average daily balance to determine the finance charge. If the periodic rate is a daily one, the product of the rate multiplied by the average balance is multiplied by the number of days in the cycle.

In addition to those common methods, financial institutions have other ways of calculating the balance to which the periodic rate is applied. By reading the financial institution's explanation, the examiner should be able to calculate the balance to which the periodic rate was applied. In some cases, the examiner may need to obtain additional information from the financial institution to verify the explanation disclosed. Any inability to understand the disclosed explanation should be discussed with management, who should be reminded of Regulation Z's requirement that disclosures be clear and conspicuous.

When a balance is determined without first deducting all credits and payments made during the billing cycle, that fact and the amount of the credits and payments must be disclosed.

If the financial institution uses the daily balance method and applies a single daily periodic rate, disclosure of the balance to which the rate was applied may be stated as any of the following:

- A balance for each day in the billing cycle. The daily periodic rate is multiplied by the balance on each day and the sum of the products is the finance charge.